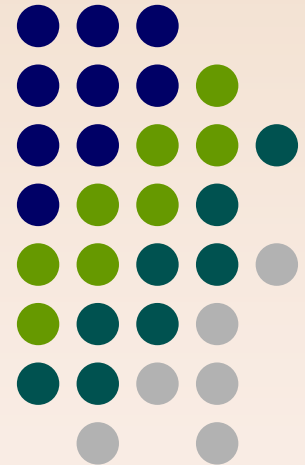




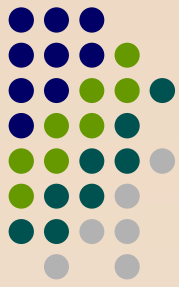
# Regulating Bankers' Pay

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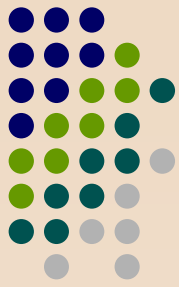
Law and Economics Workshop, November 3, 2009



# Motivation



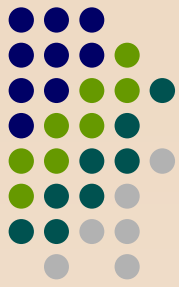
- . The financial crisis has raised concerns that executive pay in financial firms can produce excessive incentives for risk-taking. Firms and authorities around the world seek to address these concerns.
- . The G-20 leaders committed “to implement strong international compensation standards aimed at ending practices that lead to excessive risk- taking” (Pittsburg Meeting, September 2009).
- . How can executive pay in financial firms produce such incentives? What can/should be done about it?



# Main Contributions

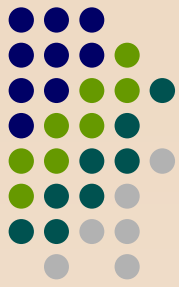
- We analyze a distortion that produces excessive risk-taking incentives that has received little attention.
- Show that corporate governance reforms aimed at aligning pay arrangements with shareholders' interests cannot eliminate this distortion.
- Develop a case for regulation of bankers' pay and analyze how regulators should monitor and regulate such pay.

# The Short-term Distortion



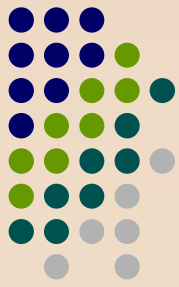
- One major factor that has induced excessive risk-taking is that firms' standard pay arrangements reward executives for short-term gains even when these gains are subsequently reversed.
- In the aftermath of the financial crisis, this distortion (first highlighted in Bebchuk-Fried, *Pay without Performance* (2004)) has become widely recognized.
- We identify a separate distortion – one that would exist even in a one-period model world in which no short-term distortions could exist.

# The Leverage Problem



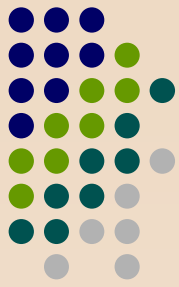
- In addition to the short-termism problem, there was a second important source of incentives to take excessive risks that has received insufficient attention: Executives' payoffs were tied to highly leveraged bets on the value of financial firms' capital.
- Compensation arrangements tied executives' interests to the value of common shares in financial firms or even to the value of options on such shares
  - => executives not exposed to the potential negative consequences that large losses could have for preferred shareholders, bondholders, and the government as a guarantor of deposits
  - => executives incentivized to give insufficient weight to risks of large losses.

# Standard structures in U.S. Bank Holding companies



- Debt at the bank operating company level
- Debt at bank holding company level
- Executives are compensated with shares in bank holding company or options on such shares.

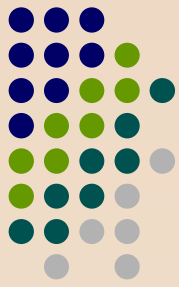
# Standard structures in U.S. Bank Holding companies (2)



Consider the following example:

- Bank operating company has 100 in assets financed by 90 of deposits and 10 of equity
- The 10 in equity comes from bank holding company, which borrows 5 and gets 5 from its common shareholders.
- Executives have common shares in the bank holding company or options on such shares.
  
- Bank contemplates project yielding
  - 20 with probability  $\frac{1}{2}$
  - (-100) with probability  $\frac{1}{2}$
- Project has a negative expected value, but it has a positive expected value effect on the manager's payoff.
  
- Why don't debtholders insist on different compensation structures? Might have insufficient incentive because much of the cost is borne by taxpayers.

# Corporate Governance Reforms

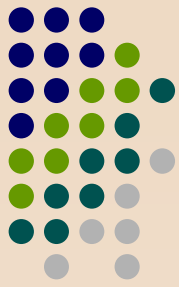


Authorities around the world have considered/adopted various measures aimed at improving the governance processes that produce pay arrangements and thus aligning pay arrangements better with shareholder interests:

- Say-on-pay
- Strengthened independence of comp committees
- Use of restricted stock



# Corporate Governance Reforms



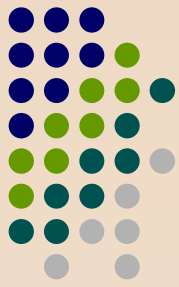
Corporate governance measures can eliminate incentives that are excessive even from shareholders' perspective.

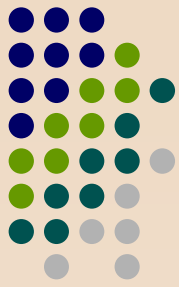
But they cannot be relied on to eliminate risk-taking incentives that are excessive from a social perspective but not from the perspective of shareholders – thus cannot be relied on to address the distortion that we identify.

[Indeed, corporate governance reforms may sometimes make risk-taking incentives even worse, not better.]

# The Role of the Government

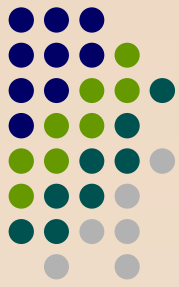
- Should the government play a role in the substantive choices of pay arrangements made by financial firms?
- For non-financial firms, the government should avoid intervening in the substantive choices that firms make. But banks are special – and their special circumstances call for a broader role for the government.





## The Role of Government (2)

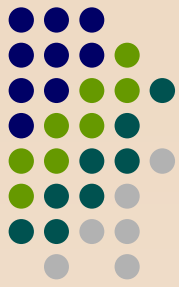
- The moral hazard basis for traditional financial regulation: Because failure of financial firms will impose costs on the government and the economy that shareholders don't internalize, shareholders' interests would be served by more risk-taking than would be socially desirable => For this reason, financial firms have long been constrained by a substantial body of regulations that restrict business decisions with respect to investments, lending, and reserves.
- But the traditional regulations of financial firms' actions are imperfect. The regulator is often one step behind => That's why it would be useful to have another tool.



## The Role of Government (3)

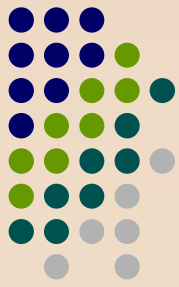
- Shareholders' interest in more risk-taking implies that they could benefit from providing bank executives with excessive incentives to take risks.
- Therefore, even if internal governance problems in financial firms were to be eliminated, regulators should monitor and regulate executive pay in financial firms.
- Regulators should recognize that decisions about risk-taking are often taken by executives, not shareholders -- regulation of pay structures could make executives work for, not against, the goals of financial regulation.

# Objections to Regulating Financial Executives' Pay (1)

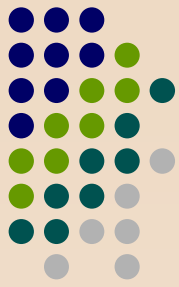


- Objection: The government doesn't have a legitimate interest in telling shareholders how to spend their money.
- Response: Given the government's interest in the safety and soundness of the financial system, intervention in pay structures will be as legitimate as the traditional forms of intervention that limit banks' business decisions.

# Objections to Regulating Financial Executives' Pay (2)



- Objection: Regulators will be at an informational disadvantage when assessing pay arrangements.
- Response: (i) More informed players inside firms don't have incentives to take the interests of depositors and the government in setting pay. (ii) Furthermore, limiting pay structures that incentivize risk-taking isn't more demanding in terms of information than traditional regulations of investment, lending, and capital decisions.



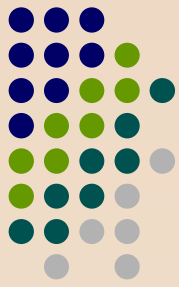
# Regulating Pay (1)

- Regulators should focus on the structure of pay arrangements – not the amount – and they should seek to limit the use of incentives to take excessive risks.
- One possible arrangement that regulators may consider encouraging:

Tying executives' payoffs not only to those of shareholders but also to those of other providers of capital to the bank.

For example, instead of giving executives  $\alpha \times (\text{value of shares})$  could give them  $\beta \times (\text{value of shares} + \text{preferred shares} + \text{bonds})$ .

# Regulating Pay (2)



- Regulation of pay can nicely complement the traditional regulation of financial firms.
- At a minimum, regulators should closely monitor pay arrangements and use information about pay arrangements in their assessment of the risks posed by a bank and their direct regulation of the banks' actions:
  - When pay arrangements encourage risk-taking, regulators should monitor the firm more closely and should consider raising its capital requirements.
  - Conversely, when arrangements discourage risk-taking, regulators may be less strict in their direct regulation of the bank's actions.



# Conclusions

- To avoid excessive incentives for risk-taking, it is not sufficient to tie executive payoffs to long-term results. The question is: long term results for whom?
- In the presence of significant leverage, a tie to long-term shareholder wealth would not be sufficient to avoid excessive risk-taking incentives.
- Corporate governance reforms cannot by themselves eliminate excessive risk-taking incentives.
- Monitoring and regulating compensation structures can be a valuable element of financial regulators' toolkit.

